

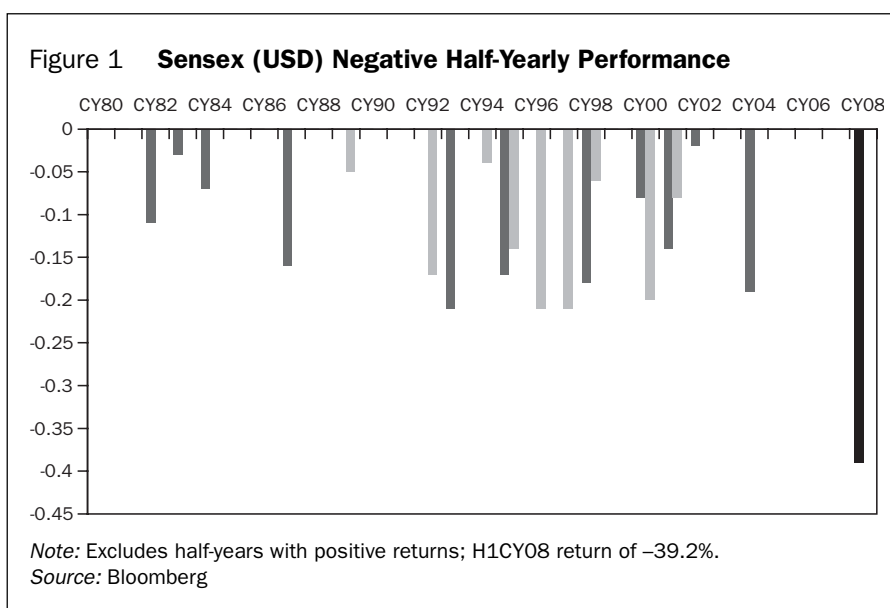
How India (Along With Everything Else) Has Changed

Jon Thorn, India Capital Management Ltd

These are “interesting times” by any definition as investors the world over experience the kind of volatility once thought to be characteristic only of emerging markets. Since the launch of our first fund on September 1, 1994 our sole focus has been Indian equities, making us one of the longest-standing foreign investors in the country and a witness to 14 years of extraordinary — and extraordinarily rapid — change.

India’s “capitalist development” dates only from 1991 (17 years), and China’s from 1979 (29 years). India is ahead of China in terms of its corporate structures, capital markets, and services; while China is way ahead of India of course in terms of industrial capacity, infrastructure, and government focus on growth. “Chindia” has brought 2.6 billion people into the ranks of the world’s producers, consumers, and savers.

The scale and speed of this emergence has expanded the constituency of investors interested in India, which was very small in 1994, to now nominally include most investors in the world. This year, though, the interest has perhaps been “mixed”. The six months to June has been by far the worst half-year in India since comparable records began



in 1979: -39% in dollar terms vs. the next worst half-year of -21%.

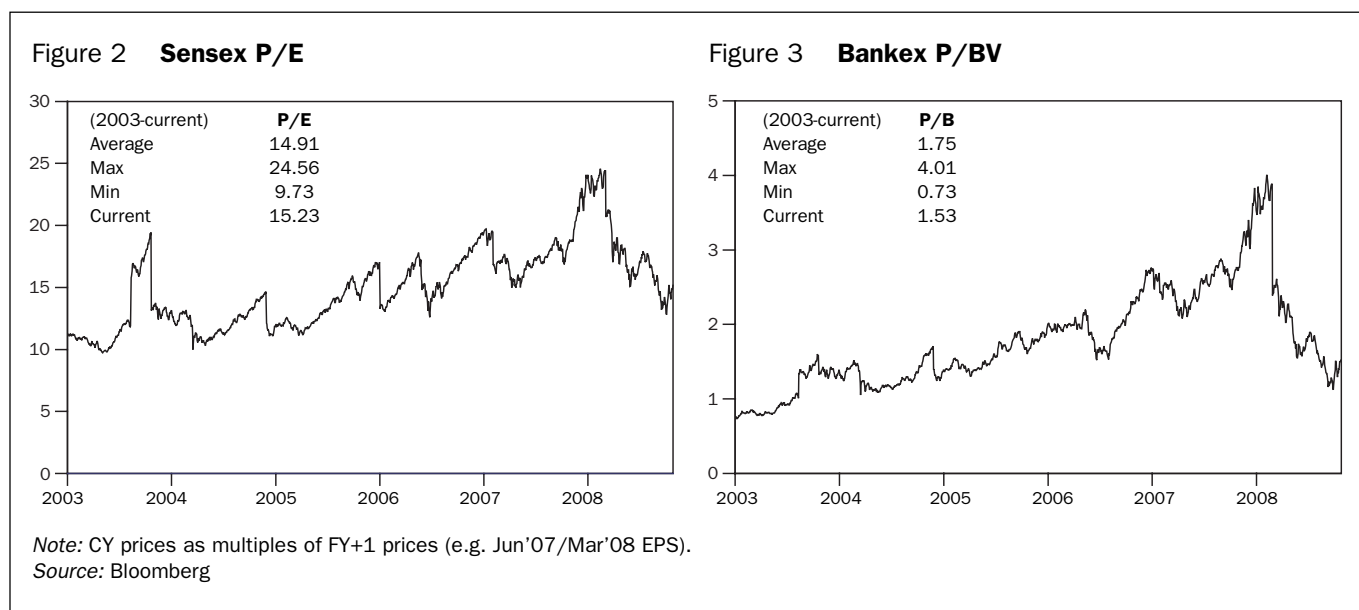
Valuations — selectively — look attractive for those companies that will emerge strongly from this stressful period, but more on that later.

NOT WHEN, BUT WHERE, WILL GLOBAL GROWTH RECOVER?

The questions at this — or, indeed, at any point — are: where do we all go from here, how did we get here, and

(specifically) what opportunities are there in India today? Marc Faber and others have defined some new global economic features that are evolving: a de-leveraging by excessively indebted asset holders, a credit contraction driven by asset reductions by capital-stressed banks, and new potential sources of capital.

But while this contraction is potentially destabilising and requires intensive care, there is another important data point here: the distressed asset sellers and stressed



banks are mostly American or European, while the holders of the increasingly hesitant new capital are Asian and Middle Eastern. The latter two are also still generating GDP growth, compared with very low growth or recession in the former. Therefore, we should expect further changes and micro-dislocations as these various parties — net debtors and net creditors — rearrange their relationships.

If bank balance sheets are compromised, they cannot lend as freely; as a result, the economy will contract and asset prices must come down. The West has this on its plate today and for quite a few tomorrows. Similarly, Western corporates and consumers have higher taxes and slower domestic demand than those in Asia, and their governments must fund incrementally higher entitlement liabilities.

If this is so, we should prefer to avoid buying or owning recently inflated assets and capital-intensive industries where the cost of capital may not be met, or where high levels of debt are needed relative to capacity.

It seems clear, also, that we should own assets that have low leverage and the highest secular sector and/or GDP growth, as they will be the first to emerge from the current global stress. Indian corporates have been capital constrained for their entire histories up until just recently, so this new global capital landscape is one in which they and their managers operate relatively comfortably.

INDIA THEN

The Indian stock market in 1994 was shallow, insular, and archaic. Trades were settled with paper share certificates, and traders employed a lot of informal leverage. While we saw an opportunity for fundamental investing, most players didn't bother with the inconvenience of research and opted instead for momentum trades.

Indian companies in 1994 were heavily leveraged — quite typical for Asia at that time — and that year saw the start of a massive and painful

restructuring of their balance sheets that for the next six years weighed on the markets, even as it put in place the conditions for corporate India's eventual takeoff.

The year 2001 wasn't good for anyone, but India had it worse than most. The stock market completed its extended collapse; the country's largest mutual fund went bust and suspended redemptions; there was 9/11; and in India there was 12/13, when the parliament was attacked and the government responded by massing 500,000 troops on the border with Pakistan. 2001 was a watershed in India, when values bottomed out and the stock market capitulated.

We spent part of the year with cash levels of 45%, but in December, with troops massed on the border, there was clearly only one thing to do: we got 100% invested.

That worked out quite well, thanks also to the regulator, who created a world-class stock market with quarterly filing of results — something that is still beyond the capabilities of the Hong Kong and Tokyo exchanges.

Most importantly, Indian companies emerged from their crushing debt burden with some of the most lightly leveraged balance sheets in the world. Debt to equity for the top 100 companies, which was 60% in 1994, fell to less than 15%. For the 30 companies in the Sensex Index, it is now well under 10%. Yes,

<10%. Cash to market cap for this group is nearly 10%. The net result for equity investors has been that any sustained uptick in GDP growth has delivered a great deal of free cash flow or capex, and often both.

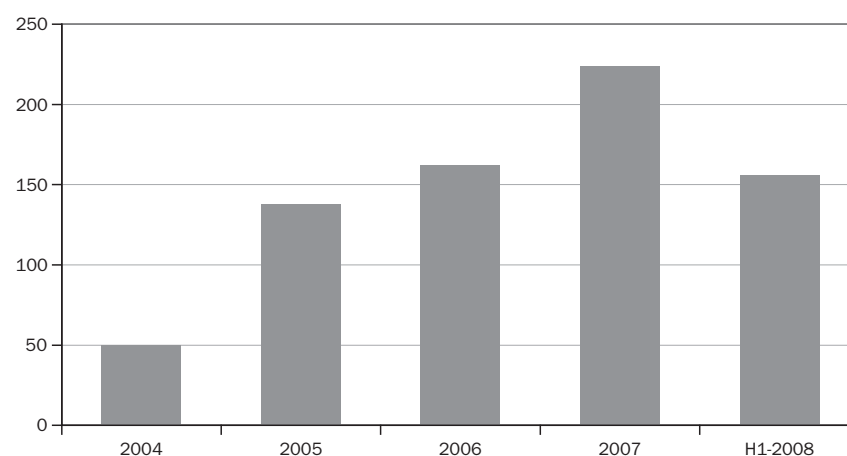
MICRO MOVES

The present finance minister, P. Chidambaram, was in the same position in spring 1997 and delivered arguably the most radical budget in Indian history which started the freeing up of both the capital management/operations of corporates and the stock market. This took some time to become visible, but as a result it was possible in India to be an entrepreneur in the same sense that we mean, and to make a lot of money by becoming a successful one. The door had opened.

Today, there are FM radio stations listed in India; world-class tech and pharma companies; one of the largest real estate companies in Asia; and the world's largest single-site oil refinery. Through giant M&A acquisitions, there are now world-scale and global metals and auto companies, and H1-2008 outward M&A is already three times the number for 2004 (see Figure 4).

Ten years ago, these companies either didn't exist, or they didn't exist in that form. The breadth of the investable universe in India has changed beyond all recognition and

Figure 4 **Number of Announced Overseas M&As by Indian Companies**



Source: Dealogic, *Asian Wall Street Journal*

reflects the expanded diversity and scale of the micro-economy on which basis India today stands alongside the US, Germany, the UK, Japan, and China (although it is well ahead of the latter two in terms of accounting standards).

Around 3Q 2003, investors started to notice India and to see that the same historic changes that had made China exciting also existed there and flowed into the market. The “India Investment Boom” is in reality only five years old, with most players having arrived in the last two to three years, but it has deep roots in the corporate, market, and regulatory reforms of the past 15 years. In our view, the “boom” has only just begun.

Also (and critically), in 2003 the Indian banking sector finally brought net NPAs to under 10%. (They are currently under 3%.) This was a huge platform for accelerating GDP growth and bank profitability.

WHAT TO BELIEVE IN TODAY?

Our assumptions about India today are therefore these:

- As it is comparatively a domestic economy with a young population, its GDP growth is not externally dependent.
- For the first time, the corporate sector is the leading actor in running the micro-economy.
- Indian banks and financials have not bought toxic US mortgages.
- It offers multiple channels for capital formation and investment — everything from FM radio stations to oil refiners.

Asian banks are in better shape than their counterparts in the West (see Figure 5), and some parts of Asia are in better-than-average shape, including India and those other countries and banks that didn’t have to “stretch for yield” (i.e. they didn’t need to buy US RMBS/CDOs etc. for a yield pick-up). Therefore, Indian GDP growth is unlikely to be limited by its banking system.

India’s household savings rate is 23.8%. Generally the future, as we see it, is all about debt, or rather the lack of it and the ability to access it which will mark out the winners.

This will apply to personal, corporate, and sovereign balance sheets.

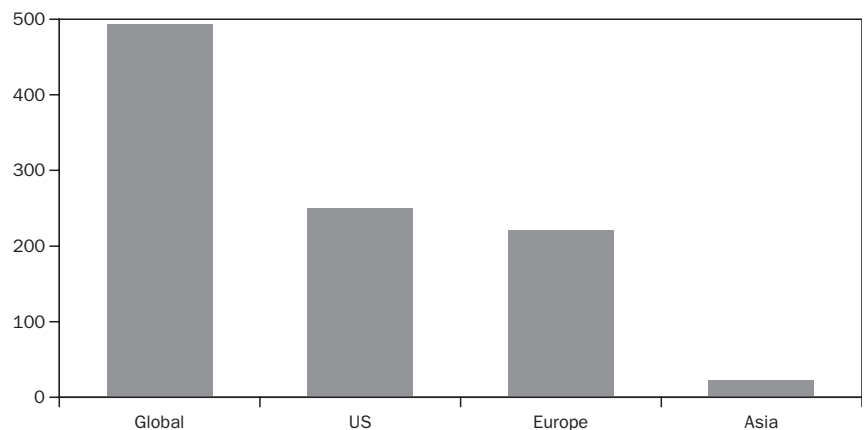
Regarding the potential for banking and corporate revenue, profits and EPS, and GDP growth, it is clear that the less indebted balance sheets can grow faster from here. As a broad guide to the possible path of consumption growth, see Figure 6 from CLSA, which shows levels of consumer debt as a percentage of GDP in 2007 in Asia and the UK.

While we are not recommending any individual securities, as a test we will review some data points on the largest Indian bank, State Bank of India (SBI), which is majority government controlled. It has over

13,000 branches (HSBC has around 10,000), and accounts for around 18% of the Indian banking system, making it one of the most domestically dominant banks in the world. So, if SBI is okay, then it’s likely that India also is okay.

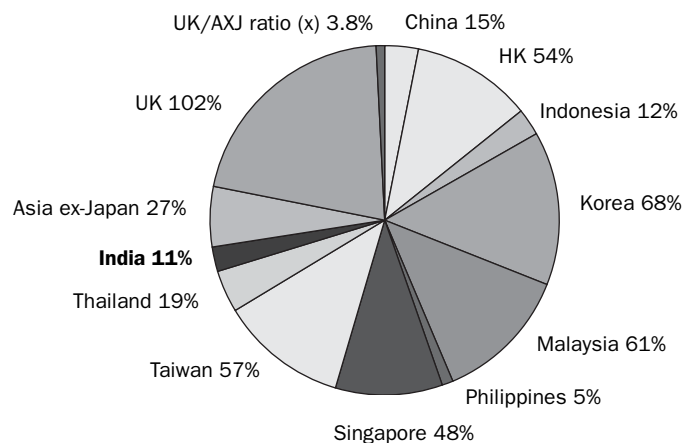
SBI’s credit growth is currently 24% and deposit growth is 23%; net interest margins are 3%; and fee income is at 30%. Gross non-performing assets are currently at 3%. Therefore, the revenue side of SBI’s business is performing very nicely. Try comparing these numbers to a Western bank. There are no (too painful to value, so let’s not) Level 3 assets or SIVs either in SBI.

Figure 5 **The Cost of Credit, Subprime-related Writedowns Since January 2007 (US\$bn)**



Source: Financial Times

Figure 6 **Asia Ex-Japan Consumer Debt Relative to UK Consumer Debt, % of 07 GDP**



Note: Including mortgages.

Source: CEIC Data, Datastream RBI, IMF, CLSA Asia-Pacific Markets

So, what does SBI cost? The stock is trading (at the time of writing) at 1.6x FY09 (year ending March 2009) adjusted book value. We expect the bank to deliver an 11.8% CAGR in earnings over FYF08–10E, with an average ROE of ~14%. Then there is SBI Life (SBIL). SBIL just recorded 120% growth in premiums, albeit from a low base. So far, only around a quarter of SBI's branches are active sellers of SBIL products, and SBIL is planning to double the number of its agents from the current 1,600.

While there are other issues to do with SBI, lack of business growth and overvaluation are not among them. So, India is probably in good shape, too.

What about the real estate market? Prices and transactions have come down, but there is no major stress. HDFC is by far India's largest single mortgage provider, and its current mortgage book is 65% loan to value, with an average tenor of 13 years. Ten years ago, or possibly even as recently as six years ago, more than 50% of residential real estate transactions would have been for cash.

Indian banks are now valued only a little higher than those in the West, but the Indian banking system has 20% loan growth and 7–8% real GDP growth at its back. Those in the West are shrinking their assets and raising fresh equity to restore their capital ratios and they operate in close to recessionary economies. The math is clear (see Figure 7).

THE (SHORT) LIST

Against this backdrop, we believe two investment themes are especially compelling.

- *Large caps with low debt.* As a group, large Indian firms may offer one of the largest collections of low-leveraged/cash-rich companies in the world, if not the largest. We have researched and invested disproportionately in this group over the past two years and we think their time has now come. We believe their unique ability to invest at a reasonable cost and to grow without

dilution will result in a superior and sustainable ROE. They also serve a domestic consumer market that is itself among the world's least indebted, youngest (i.e. least dependent), and fastest growing.

- *Special situations in smaller companies.* Some — highly selective — investments in small and midsize Indian public companies now offer some of the best attributes of private equity transactions in other markets. These include compelling valuations *in exchange for restricted liquidity*, strong management, and potentially transformative opportunities. Entry valuations for these investments are now attractive, as many companies need growth capital at a time when the supply of equity has declined sharply. Figures 8–10 show much-diminished IPO and PIPE proceeds. It looks like an opportunity; though one that will play out over time. We raised a new fund with a private equity structure, India Capital OpportunitiesSM 1, from a small group of blue chip investors in 2007 and which is now fully invested. We are identifying an increasing number of these opportunities, many of them proprietary.

A number of other approaches seem to us relatively less promising today:

- *Momentum trades in small companies.* What investments in smaller companies don't offer is a

quick flip. As a group, they offer more volatile operating performance and usually higher debt than their larger peers. While the Sensex index of large caps has fallen 31% year to date, the mid and small-cap indices are down 45% and 52%, respectively. Some of the highest-profile small cap names have fallen even further as stressed sellers find almost no buyers at all.

- *Traditional venture capital and buyouts.* Traditional private equity could well blossom in India, but is not where we see the greatest opportunity. India has the second-highest number of public companies in the world, second only to the US. For example, there are more than 70 listed Indian cement companies, which collectively deliver more than 85% of sector revenues, leaving few appealing privately held companies for a pure PE investment. As a result of this dynamic, a great deal of capital raised for private equity in India has thus far been deployed in the public markets. Buyout funds have found the going particularly hard, as deal leverage has been difficult to obtain even in the best of times and openness to control investments has proved almost nonexistent.

- *Buying the index.* In the quarter ending June 2008, Sensex companies beat consensus earnings estimates for the 10th straight quarter, but their

Figure 7 Performance YTD of World Financials Index, US\$ (January–July 2008) and Price to Book

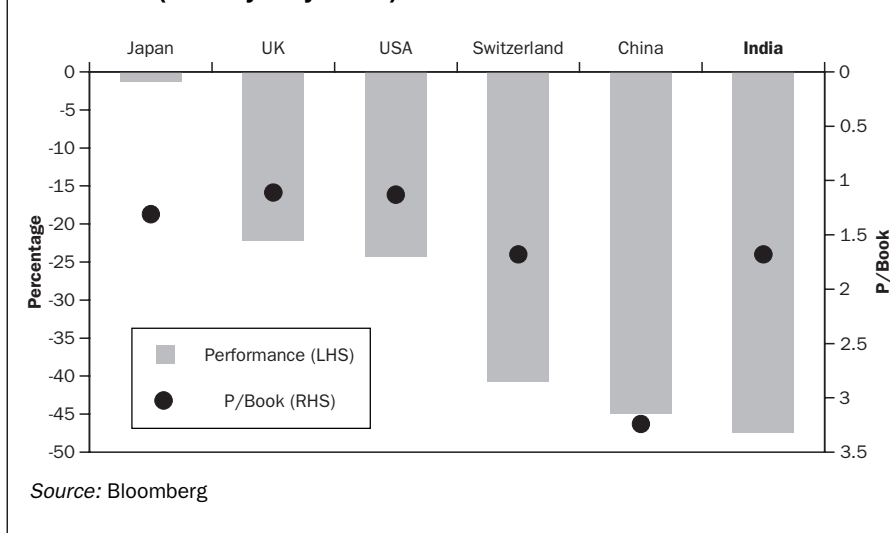
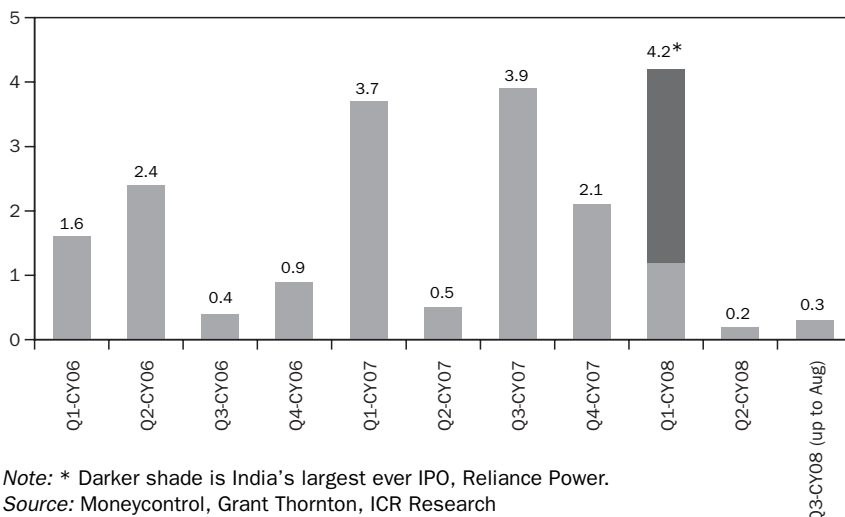


Figure 8 IPO Data – Last 10 Quarters (in US\$Bn)



performance has grown increasingly disparate as the best companies perform well and others' results have moderated. A major brokerage has this year downgraded estimates for more than two-thirds of its coverage universe, but has also upgraded 22 stocks since June alone. This indicates a new environment in which strong companies will deliver performance far superior to the average.

SO, WHERE DO WE ALL GO FROM HERE?

The IPO/PIPE door will open again, and perhaps not so far down the line as India is seen to offer domestic growth, in the context of a new global environment where access to credit and a growing market will be the exception.

Yesterday's market will definitely not be tomorrow's. What has changed and what is attractive now in India are the breadth of the investable market and the select character, as we see it, of the great investments within it. There will be fewer but bigger opportunities for some companies, as well as greater scalability given the size and complexity of the growing GDP.

It is very much a stock picker's market in which the index may not generate great performance for a while.

The big change, therefore, is that the primary driver of returns will be the *specific opportunity*, and not the *liquidity* or the *asset class* of the investment. That is where we are focused and how we have organised our funds. This opportunity rests on 17 years of macro and microeconomic reform, but is, in our view, still decades from maturity.

Figure 9 PIPE Deals – Significantly Down (H1'08 vs. CY'07)

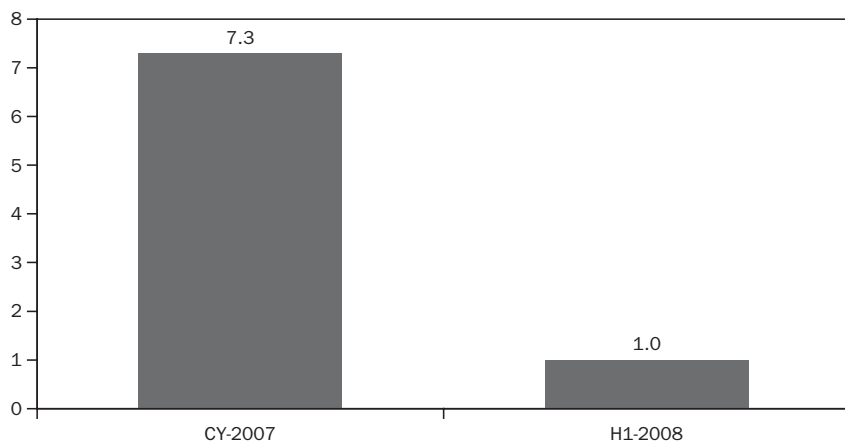
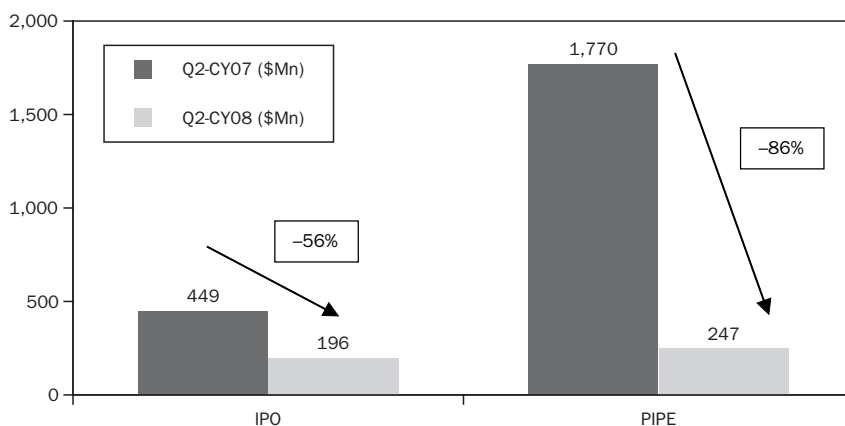


Figure 10 IPO and PIPEs – Q2'CY08 versus Q2'CY07



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